

STATE OF VERMONT
PUBLIC SERVICE BOARD

Docket No. 7336

Petition of Central Vermont Public Service)
Corporation for approval of an Alternative)
Regulation Plan pursuant to 30 V.S.A. §218d)

CENTRAL VERMONT PUBLIC SERVICE CORPORATION
REPLY BRIEF

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I. INTRODUCTION

In this Reply Brief, Central Vermont Public Service Corporation (“CVPS” or the “Company”) responds to the Brief and Proposed Findings of the Department of Public Service (“Department” or “DPS”) with respect to CVPS’s proposed alternative regulation plan (“CVPS Plan”). We will provide only short rebuttal accompanied by citations to our initial Brief and Proposal for Decision (“CVPS Brief”) or the record. In summary, the DPS’s proposed modifications to the CVPS Plan would, in effect, fail to establish just and reasonable rates and a system of regulation in which CVPS has clear incentives to provide least-cost energy service to customers.

II. RESPONSE TO DPS BRIEF

A. The DPS Brief and Proposed Findings (“DPS Brief”) recommends that the “Unicap” and “Subcap” proposed by CVPS be replaced by a “non-power cost cap” of \$6.2 million in 2009 and \$8.7 million in 2010. DPS Brief at finding 11. The DPS is adding these caps to a non-power spending base of \$122.4 million derived from the 2008 MOU cost of service.¹ Confidential Exh. CVPS-Rebuttal-PJK/RDC-3. CVPS testified that this non-power spending number of \$122.4 million does not compensate CVPS for its expected cost of service in 2008. Tr. 7/9/08 at p. 193, line 1 to p. 194 line 19 (Keefe/Cook).

The DPS proposal of a \$6.2 million non-power cost limit in 2009 would, in effect, result in a total non-power cost cap of only \$128.6 million. CVPS believes the cap level offered by the DPS would threaten the ability of CVPS to deliver safe and reliable service and would also fail to provide CVPS with a reasonable opportunity, under sound and economical management, to earn a fair rate of return. In fact, at \$128.6 million, the DPS is proposing a cap for 2009 that is less

¹ The DPS non-power spending calculation under the 2008 MOU cost of service excludes Regulatory

than CVPS's non-power spending of \$129.9 million in 2007. Confidential Exh. CVPS-Rebuttal-PJK/RDC-6.

Based upon its current business plans, CVPS has forecasted non-power spending in 2009, of \$135.9 million (Confidential Exh. CVPS-Rebuttal-PJK/RDC-3), largely to implement the increased activities detailed in its Asset Management Plan, a plan that has the support of the DPS's engineering staff. Exh. DPS Cross-1. Despite that support, and without factual evidence showing that CVPS expenditures are greater than required to support safe and reliable service, the DPS is recommending a total 2009 non-power spending cap that is actually \$7.3 million less than CVPS's 2009 forecast. Confidential Exh. CVPS-Rebuttal-PJK/RDC-3. The spending cuts needed to comply with that cap would be significant and would directly harm customer service and CVPS's ability to return to investment grade.² A similar problem exists for 2010 where the DPS recommends a total non-power spending cap that is \$2.7 million less than CVPS's current forecast. Id.³

Even if the independent Business Process Review (described in the CVPS Brief at finding 7) ultimately concludes that CVPS is operating efficiently, the DPS nevertheless would require huge spending cuts with no suggestion of where the cuts should occur. Tr. 7/10/08 at p. 146, lines 13-18 (Behrns)⁴; id. at p. 142, lines 17-19.⁵ The DPS's proposal implies an unwillingness

Asset/Liability Amortizations.

² Keefe/Cook reb. pf. at 13, lines 12-16 ("The financial community at large, and the credit rating agency Standard & Poor's in particular, may be skeptical of the value of an alternative regulation plan that, as designed, produces materially large cost disallowances and effectively removes incentives for the Company to improve its financial results and removes its ability to earn its allowed return.")

³ We should note that cost of service forecasts are not perfect predictors of future period costs. We have observed, for example, that our 2008 spending level is now higher than what is represented in the 2008 MOU cost of service. Tr. 7/9/08 at p. 194, lines 14-19 (Cook). Our 2008 costs turned out to be higher with the passage of time given changes in business circumstances. Tr. 7/9/08 at p. 196, lines 15-17 (Keefe). Accordingly, we are asking for a cost cap formula that allows room for changes in business circumstances -- including inflation.

⁴ Mr. Rocheleau: "And if the process review were to determine that the company is exercising cost discipline, would you still recommend a 5 million dollar cut in the company's spending in order to just get to the cost of service level for the subcap items?" Mr. Behrns: "Yes. ..."

to accept the outcome of the independent review if it does not favor the DPS's position. If the independent review does not recommend such cuts, and CVPS does not make such cuts, CVPS would have no hope of earning a fair rate of return.⁶ Accordingly, CVPS continues to recommend the CVPS Plan as proposed.

If the Public Service Board ("Board" or "PSB") determines that a non-power cost cap is more appropriate than CVPS's proposed Unicap and Subcap structures, the Board should adopt the "Lowry Option 3" non-power cost cap with the VGS-type O&M cap, explained at page 67 of the CVPS Brief. The "Lowry Option 3" in combination with the VGS-type O&M cap would be based initially on CVPS 2007 actual, audited results. The cost cap would be constructed using a forecasted CPI inflator to which CVPS is subject, with an offset for productivity, and adders for customer growth and the uptick in spending for CVPS's Asset Management Plan. There would be an additional incentive, as in the VGS plan, allowing CVPS to recover in rates 50% of the difference between the level of its operational costs as determined by its annual COS filing and its cap. This combination would result in a non-power cost cap that would require cost discipline and induce CVPS to be efficient, but would not create arbitrary disallowances that would jeopardize necessary spending. CVPS Brief at 67.

B. The DPS argues that "[t]he Unicap as proposed by CVPS functions as a cap on non-power costs, any power costs not recovered would be deferred for later recovery, and the Unicap is similar to the non-power cost cap included in the Green Mountain Power Alternative

⁵ Mr. Rocheleau: "Are there any particular areas where you suggested that cut occur?" Mr. Behrns: "No. We don't have any specific recommendations...."

⁶ The DPS also argues that imposing cost cuts through the DPS caps will enhance the Company's ability to achieve an investment grade rating. DPS Brief at 3, 4. The evidence, however, directly contradicts this view. Imposing the cost reductions sought by the DPS will simply force CVPS to reduce its spending which could affect customer service and reliability, or cause CVPS to consistently under-earn. Tr. 7/9/08 at p. 219, line 23 – p. 221, line 10 (Keefe). The need for competitive earnings and an investment grade rating is growing more urgent as the Company seeks to raise new capital and negotiate new long-term power agreements in markets where access to capital is very uncertain and cost inflation is climbing. Tr. 7/9/08 at p. 224, lines 10-13 (Keefe).

Regulation Plan, except that the Unicap would allow recovery of much higher amounts than allowed for GMP.” DPS Brief at finding 4.

This, in fact, is a mischaracterization of the Unicap that confuses the roles of the mechanisms proposed in the CVPS Plan. The Unicap is a rate cap and not a cost cap. While the DPS is correct that application of the Unicap could, potentially, result in the deferral of power costs, such deferral would negatively impact cash flow and incur the loss of the time value of money. Tr. 7/9/08 at p. 61, line 21, and p. 62, line 16 (Deehan). Therefore, a rate cap like the Unicap has the secondary effect of inducing CVPS to avoid such deferrals by being efficient with all of its expenditures. Tr. 7/9/08 at p. 63, lines 1-14 (Deehan). In addition, the DPS’s statement that “the Unicap would allow recovery of much higher amounts than allowed for GMP” does not accurately reflect the differences between the CVPS and GMP rate caps. While the GMP Plan does have a rate cap on power-related accounts (1 cent/ kwh), it is only effective on their quarterly PCAM adjustment charges. It is very limited in scope, and their base rate filings have no rate cap at all.

C. The DPS asserts the Unicap would allow for annual rate increases of over 7% during the term of the Plan and “contemplates annual rate increases of 7%.” DPS Brief at finding 5 and at p. 2. The DPS does not provide any evidence that the CVPS Plan contemplates 7% increases. On the contrary, the Unicap caps the maximum annual rate increase at 7% -- a feature that protects consumers and which is not found in either of the other Vermont alternative regulation plans. CVPS Brief at p. 32. The DPS seemingly ignores CVPS’s Annual Rate Increase projection set forth in Confidential Exh. CVPS-Rebuttal-PJK/RDC- 3. That exhibit shows expectations of rate escalation of between 3.35% to 6.36% a year over the 2009 to 2011

period, and each rate filing is subject to the review of the DPS's consultant and the Board.⁷

Thus, despite the proposed higher spending on non-power items, the rate impact on customers is expected to be lower than the Unicap. In addition, updated expectations of revenue from the sale of excess power in 2009 will significantly reduce the 2009 rate increase to customers.⁸

Confidential Exh. CVPS-Rebuttal-PJK/RDC-3 at note 2; CVPS Brief at finding 84. As such, the DPS's "contemplated annual rate increases of 7%" contention has no basis in the projections that accompany CVPS's business plans.

D. The DPS criticizes the CVPS Plan because it includes a Subcap that places a limit on some, but not all, of the costs that the DPS considers controllable. DPS Brief at finding 8. The proposed Subcap places a cap on spending in areas that CVPS said are its "most controllable" costs. Deehan pf. at p. 23, line 16 to p. 24, line 3. The Subcap therefore encourages CVPS to focus its efforts where additional savings are the most likely, without penalizing CVPS for cost increases in the areas impacted by its Asset Management Plan, areas where CVPS has little or no control, and areas where activities on behalf of customers are necessarily increasing. CVPS Brief at findings 125-127, 136, 137, 144-146, 149.

E. The DPS criticizes CVPS for pointing out that one method of review includes

⁷ Furthermore, except as specifically provided in the Plan, our annual cost of service filings must comply with traditional ratemaking principles for establishing just and reasonable rates. Tr. 7/9/08 at pp. 13-15 (Deehan). Moreover, the independent Business Process Review report will be published before we are required to file our 2009 Base Rate cost of service. Under the Docket No. 7321 MOU, we generally are expected to implement all the Review's recommendations. To the extent cost reductions are identified by the Review as achievable during the 2009 rate year, we will have an incentive to include them in the cost of service. Otherwise, we would risk the suspension of the Base Rate change under the Plan or a rate investigation. As a result of these protections, there is a low risk to customers if the Board rejects the cost cap amounts suggested by the DPS and adopts the CVPS Plan. CVPS Brief at 66.

⁸ In its Form 10-Q for the quarter ending June 30, 2008, CVPS noted that its positive results for that quarter were driven primarily by higher than expected revenues from sales of excess power into the wholesale market. See Form 10-Q for period ending 6/30/07 at page 26 bullet beginning "Resale Sales..." CVPS requests that the Board take administrative notice of this Form 10-Q. It was filed with the Board and parties in this docket by letter from CVPS attorney Jeanne Burns, dated 8/12/08, responding further to Board questions about proposed equity issuances. Also, as CVPS stated in an earlier letter from Jeanne Burns, dated 8/4/08, "the Company has foregone the sale of the remainder of our 2009 excess energy and all of our 2010 and 2011 excess energy in order to avoid collateral calls and a liquidity crisis." Accordingly, the 2009-2011 revenue from excess power sales is not yet firmly established.

prudence reviews, and states “[m]ere avoidance of a finding of imprudence is not equivalent to an effective incentive ‘to operate as efficiently as possible’” DPS Brief at 3. CVPS submits that “[m]ere avoidance of a finding imprudence” is a mischaracterization of the reviews and incentives contemplated in the Plan. There are a number of mechanisms that serve as sources of incentive in the CVPS Plan that the DPS overlooks. The PCAM and ESAM banding features -- features in common with the other Vermont plans -- provide a direct incentive to CVPS to improve its financial results by efficiently managing any and all costs. The Subcap directly restrains the costs of CVPS’s administrative-type functions. CVPS Brief at findings 131-133, 138-142, 147-149, 151. In addition, the Plan provides for several levels of review (of which a prudence review would be the least desirable from all perspectives). CVPS Brief at findings 78, 135, 137, and discussion at pp. 60, 63, 69, 70. The DPS criticisms of the Unicap fail because they are based on a misunderstanding and mischaracterization of what the Plan’s mechanisms, acting together, accomplish.

F. The DPS asserts that its “formulaic determination of the cap is likely to facilitate administration of the plan by limiting the need for debate and potential litigation” and that “[m]ore complex proposals advanced by the Company would be more costly and likely to lead to more contention.” DPS Brief at finding 10. We disagree. If the PSB were to accept either CVPS’s proposed Plan or the Lowry Option 3 index approach, all that would need to be updated each year during the Plan’s term is the published inflation value, which is neither costly nor contentious.

G. Regarding the DPS’s discussion of CVPS’s earnings sharing adjustment mechanism in general (DPS Brief at findings 13-16) and its contention that it is unfair to impose additional risk (and potentially cost) on ratepayers in these circumstances (DPS Brief at 6), CVPS submits that it is in the interest of customers for CVPS to return to an investment grade

credit rating and that it is fair and reasonable to impose a little additional risk (and potentially cost) on ratepayers when that risk is equally accompanied by a comparable benefit (and potentially lower costs). Tr. 7/9/08 at p. 203 and p. 204, lines 2-4 (Cook) (narrower dead band means customers share both a little more potential risk and reward). CVPS also believes it is fair and reasonable that CVPS be subject to the same ESAM parameters as GMP only when CVPS reaches the same credit rating as GMP when its ESAM became effective.

The DPS does not dispute that CVPS is currently below investment grade, and does not argue that a narrower dead band/sharing band mechanism is inappropriate for a below investment grade company. Rather, the DPS's argument appears to be motivated by a desire to penalize CVPS for what it views as the malfeasance of CVPS in challenging the DPS's recommendations in Docket Nos. 6946/6988.⁹ DPS Brief at p. 6 ("It is unfair to impose additional risk (and potentially cost) on ratepayers in these circumstances...."). See also tr. 7/9/10 at 213, lines 13-17, and lines 23-25 (Commons).¹⁰ The DPS is apparently ignoring the customer benefits of an investment grade credit rating. For example, customers will benefit from better credit terms in long term power contracts if CVPS is upgraded by S&P from its current credit rating (BB+) to the same credit rating as Green Mountain Power Corporation (BBB). If CVPS had a BBB credit rating, it would effectively have a "free line of credit" of \$87 million, rather than just \$25.5 million, in its current power contracts to support its power purchase obligations on behalf of customers. Tr. 7/9/08 at 119-122 (Deehan); Exhibit CVPS-WJD-7.

CVPS is looking to the future with its Plan. The DPS is apparently looking back. It argues that CVPS's below investment grade status is the result of a "litigation strategy" three rate

⁹ In support of its argument, the DPS cites to Mr. Deehan's testimony at "tr. 7/9/08 at 68, 116-122 (Deehan)." We could find no testimony of Mr. Deehan's at these references that is germane to the DPS's argument.

¹⁰ Mr. Commons: "Has the company held itself accountable, and, if so, if the company feels that it should be accountable, doesn't that suggest that ratepayers should not bear costs flowing from the credit downgrade? ... Have

cases ago. DPS Brief at 6.¹¹ While CVPS disagrees with that characterization, CVPS acknowledges that it has the responsibility to establish and maintain positive communications and relationships with our regulators and to achieve an investment grade rating. *See, e.g.*, tr. 7/9/08 at p. 205, lines 11 to 12 and p. 212, lines 22 to 25 (Cook). We believe it is time to put these disagreements behind us and, instead, focus on what is needed to obtain the customer benefits of an investment grade credit rating.

H. The DPS recommends that recovery of unanticipated energy efficiency or distributed-resource costs should be evaluated to determine if they warrant amending the Plan. DPS Brief at finding 3. CVPS disagrees. The PSB addressed the issue of unanticipated distributed resource cost in the VGS Alternative Regulation Plan docket. The PSB did not require amending the VGS Plan but did require VGS to make a filing describing the unanticipated expenditures in the process of requesting deferred cost and subsequent revenue treatment. Docket No. 7109, Order entered 4/4/07, at 4. The CVPS Plan conforms to the Board's order in Docket No. 7109 and the DPS has not identified where the CVPS Plan is inconsistent. CVPS recommends that the Board not impose a different condition, without support, when the DPS's condition is at odds with a recent PSB order.

I. Finally, the DPS suggests that earnings sharing adjustments should be made only once per year. DPS Brief at finding 3. We submit that our minor refinement of using refreshed kWh sales forecasts to fine-tune the ESAM percentage rate at the time of the annual Base Rate filing (midway through the ESAM's annual cycle) is not a material difference. Refreshed forecasts should be more accurate and their use should reduce the magnitude of under or over

any individuals experienced consequences that are commensurate in magnitude and time with the credit downgrade?"

¹¹

As noted at the hearing, the DPS has since settled two CVPS rate cases since Docket Nos. 6946/6988, and did not raise any imprudence issue in those cases or in this docket. Tr. 7/9/08 at p. 214, lines 18-24 (Chairman Volz) and p. 216, lines 10-17 (Rocheleau). CVPS respectfully submits that a review of S&P's June 10, 2005 downgrade

collections during the last six months of each cycle (balances that then roll into the next ESAM calculation). We believe this minor refinement will be a straightforward, transparent recalculation. If the Board feels, for the sake of simplicity, that it is better to avoid this step, CVPS would not object.

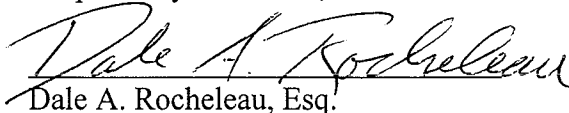
III. CONCLUSION

For the reasons set out above and in the CVPS Brief, we ask the Board to approve the CVPS Plan, effective November 1, 2008. With respect to the attendant adjustment in CVPS's allowed return on equity ("ROE") of 50 basis points upon the effective date of the Plan, CVPS requests that the Board order include an instruction that the value of the lower ROE for the months of November and December 2008 shall be booked in CVPS's financial records as a regulatory liability and shall appear as a credit for ratepayers in CVPS's Base Rate cost of service for rate year 2009. CVPS also requests that the CLF Stipulation be approved.

Finally, if the Board considers a non-power cost cap in lieu of CVPS's proposals to be advantageous, we respectfully request the Board adopt "Option #3" as described in Exh. CVPS-Rebuttal-PJK/RDC-6 as a reasonable non-power cost cap formulation and that it be implemented consistent with the 50% sharing model approved for the VGS alternative regulation plan.

Dated in Rutland, Vermont this 22d day of August, 2008.

Respectfully submitted,



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